VALUE CREATED BY HEDGE FUNDS

Pranay Doshi

Abstract: Working at a hedge fund is a dream for many people. They leap at any chance to use their background in hopes of obtaining a high-paid future at the fund. However, as more light is being shed on the ethical value behind large investment banks, the same is coming upon the barely regulated hedge fund industry. Many within these funds leave wondering why they are using their PhD to sit at a desk making hundreds of trades a day. In this paper, I will discuss the ethical value created by these funds. Specifically, I aim to explain if these funds are creating value for other people or are just realizing giant profits, because some other traders/investors with less resources lost money.

Background on Hedge Funds

The word hedge means to practically limit risks by simultaneously taking the opposite position; thus ensuring that, either way, you 'win'. Hedge funds are actively managed investment pools whose managers use many strategies, often using leverage in hopes of beating average investment returns. The use of leverage is critical here since funds are not using their own capital in these investments. Rather, they use borrowed money at a low-interest rate to create gains and pay off the interest.

While both hedge and mutual funds are closed-end funds, they are drastically different. Mutual funds are available for investment to the public and are fairly liquid. Hedge funds, on the other hand, are only for accredited investors with an income of over $200,000 and a net worth of over $1,000,000. This restriction has allowed funds to operate without much oversight from the SEC. The fee structure of hedge funds is also notably higher than mutual funds. The well-known 2/20 structure is 2% management fees, placed regardless of return, and a 20% performance fee if the return is higher than a specified amount. In recent times, this model has changed to 2/30 and 3/30 for certain funds. There are many types of hedge funds as well, but a few of the most sought-after are global macro (funds that try to profit from broad market swings from events), equity (funds investing in lucrative stocks while shorting overvalued securities), and relative value (funds seeking to exploit temporary differences in the prices of related securities).

While it entirely depends on the product you are trading and the fund you are at, probability and statistics are highly involved in hedge fund strategies. Machine learning and artificial intelligence are used to create complex algorithms capable of high-frequency trading. An example could be using linear regression and neural networks to forecast the movement of an asset prior to taking a position on it. Additionally, stochastic processes (Brownian motion and Markov models) are applicable to strategies through time series. Lastly and most sophisticated is the pricing of any derivative brought upon stochastic calculus, which results in the need for a quant researcher at the fund. It is also evident that the basics of options, swaps, futures, and forwards should be known.

Negative Ethical Implications of Hedge Funds

The debate on the ethical value of hedge funds is widely influenced by negative implications. Most fund managers pay only capital gains rates on their remuneration (15 percent), instead of income tax rates for top bracket earners (35 percent). They argue that this lower rate is appropriate because of the risky nature of hedge fund investments. Ironically, secretaries of fund managers are paying a higher tax rate than their managers who earn hundreds of millions of dollars. There was an attempt in 2007 by legislation to remove this ‘perk’ but in the end, it failed. Aside from the unfair tax benefits, the negative implications can be split into the zero-sum game argument, ‘duping’ investors and causing social harm.

1. Zero-Sum Game

One of the main objections is that hedge funds and big investors make profits by exploiting the weaknesses of other traders and investors. With every winner in the financial markets, there will be a loser, and this is known as the zero-sum game. Therefore when these funds realize these profits from trades, it is at the expense of other traders or resources. There is also the “heads-I-win; tails-you-lose” phrase (Donaldson). , i.e., if the fund loses badly for investors, it still receives more than twice the normal fees charged by large investors through the management fees. But if the fund wins for investors, it receives not only twice the normal fee *but also* 20 percent of the profits due to the performance fees.

2. Duping Investors

In 2007, Bear Stearns CEO James Cayne spoke confidently about the health of his firm, and within a few days there were announcements about the firm's bailout by the government. There are many claims that state hedge funds have a similar tendency to dupe investors with false information. This sheds light on how easily funds and banks can provide stakeholders false information for their own well-being. Going back to the fee structure, this can be seen as taking advantage of their investors with claims that they will give them these amazing returns. These fees are much higher compared to other investment managers. Warren Buffet, in a letter to Berkshire Hathaway shareholders, "called the fee arrangements of hedge fund managers grotesque and warned shareholders to not expect high returns" (Donaldson). Interestingly, if Berkshire Hathaway investors had invested in a 2/20 fund, they would have only created about $5.6 billion instead of $62 billion by investing in the firm itself.

As mentioned before, with a lack of regulation hedge funds are structured to block transparency for strategic reasons. Investments in these funds are considered illiquid as they often require investors to keep their money in the fund for at least one year, a time known as the lock-up period. They do not provide their own investors and governments information on their returns and strategies, in order to protect their competitive advantage. It was also impossible to get accurate information about their earnings due to not having to file quarterly reports with the Securities and Exchange Commission (SEC). Thus, there is a conflict of interest between fund operators and their investors: the fund could potentially be doing poorly but would hide the loss from investors with hopes that it will improve later. All this lack of transparency gave them unlimited freedom when making strategies.

3. Social Harm

The impact on society is a prevalent concern with hedge funds. Profits generated by hedge funds and investment banks can contribute to income inequality and expand social and economic disparities. If these financial entities continue in their unethical actions, it will lead to distrust in the financial system as a whole. Additionally, if a hedge fund engages in insider trading or market manipulation, the price of a stock may be artificially inflated, causing individual investors to buy in at a higher price and suffer losses when the price eventually drops. Companies can also be affected if the fund decides to go short on that company, inherently bringing its stock price down along with its reputation.

Positive Ethical Implications of Hedge Funds

Collectively this industry is fairly large with about 300,000 employees worldwide. Aside from taking risky investments and generating higher returns, these funds have contributed with positive value leading them to rival the negatives. Hedge funds can add value to the economy by providing a source of capital, helping to manage risk, and providing liquidity.

1. Source of Capital & Liquidity

Hedge funds provide a valuable source of capital for companies and investments that might not receive funding from traditional sources. Managing that capital encourages those seeking capital to demonstrate good qualities to be invested in, a sort of natural regulation. An example would be firms taking on ESG initiatives in hopes of being a better investment for a fund. Since ⅔ of funds AUM is pension funds, university endowments, and charitable foundations, if these funds perform well, pensions will go up, universities will have more money, and insurance premiums will go down. Investment banks can similarly help companies raise capital by underwriting securities offerings, providing advice on mergers and acquisitions, and engaging in other types of financial transactions. Doing so helps ensure that companies have access to the capital they need to grow and expand their operations.

Funds also assist in liquidity and stability to markets through capitalizing on inefficiencies and market opportunities and also give investors access to investments they would not normally get. Hedge funds and investment banks can help create liquidity in markets by acting as market makers, providing liquidity to buyers and sellers by buying and selling securities themselves. This ensures that markets remain efficient and stable, and that investors have access to the capital they need to make investments. With market stability, companies are often misvalued and these funds can step in and raise awareness for them helping them be more fairly priced. An overvalued firm would be shorted heavily and bring it down and the opposite with an under-valued firm.

2. Social Benefit

The impact of hedge funds and investment banks on society is multi-faceted and can have both positive effects. Investing in innovative and promising ventures can help drive economic growth and create jobs, which ultimately benefits society as a whole. Additionally, investment banks can provide crucial advisory services to companies to ensure they are operating efficiently and contributing to the overall economy. One specific way hedge funds contribute to society is by donating large sums of money to non-profit organizations. These donations support a range of causes including homelessness, children's welfare, world hunger, arts, and education. For example, the Robin Hood Foundation, created by hedge fund managers, donated $132 million to 210 poverty-fighting programs in NYC last year. Furthermore, many hedge fund managers volunteer their time by serving on the boards of non-profit organizations.

Recommendations

Hedge funds do provide some ethical value, but there is a need for them to be altered to mitigate the potent negatives. These funds need regulations where they must submit 10K and 10Q filings to the SEC. Thus everyday investors will know their earnings and there will be less misinformation. Next, when banks lend to these funds, they must be more transparent in their strategies so the bank is aware of the apparent risk before the investment. Lastly, some funds are now employing a no-fee structure, such as Convoy Funds. This is able to combat the infamous 2/20. If hedge funds are well managed, they will prove to be less volatile than most assets and be a prime investment for college endowments, foundations, pension funds, and other investors who value stability,

Works Cited

"Does the Hedge Fund Industry Benefit Society?: Portfolio for the Future." *CAIA*, https://caia.org/blog/2015/03/30/does-the-hedge-fund-industry-benefit-society#:~:text=Hedge%20funds%20contribute%20large%20amounts,hunger%2C%20the%20arts%20and%20education.

Donaldson, Thomas. "Society for Business Ethics Conference Dialogue: Part II HEDGE FUND ETHICS."

"How Hedge Funds Create Criminals." *Harvard Business Review*, 23 July 2014, https://hbr.org/2010/12/how-hedge-funds-create-crimina.

Team, The Investopedia. "What Is a Hedge Fund? Examples, Types, and Strategies." *Investopedia*, Investopedia, 11 Jan. 2023, https://www.investopedia.com/terms/h/hedgefund.asp.